Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Harman	Analyst:	Marion Mann DeJong	Bill Number:	AB 377
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/20/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Water's-Edge/FTB Follow IRS Profit Split Rules for Audit

SUMMARY

This bill would allow a water's-edge taxpayer that has an affiliate company located in Puerto Rico to account for profits by assigning 50% of its profits to each entity.

PURPOSE OF THE BILL

According to the sponsor, the purpose of the bill is to conform to the federal method of assigning income between a U.S. parent and an affiliate company located in Puerto Rico.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

At the request of the author's staff, department staff is drafting amendments to clarify the operative date of the bill and to resolve the conflict between the two presumptions. See "Implementation Considerations" below. The amendments are not in this analysis, instead they will be provided to the author separately.

ANALYSIS

FEDERAL/STATE LAW

Under current federal law, corporations organized in the U.S. are taxed on all of their worldwide income, regardless of source, and are generally allowed a credit for any taxes paid to a foreign country on their foreign source income.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Gerald H. Goldberg	03/26/01
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Under current federal law, foreign corporations engaged in a U.S. trade or business are taxed at regular progressive U.S. rates on income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income or ECI. However, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on certain fixed, determinable, annual, or periodic income (usually investment income) from U.S. sources.

Unless the taxpayer qualifies and elects to file its return on a consolidated basis, federal law uses the "separate accounting method" to determine the amount of a corporation's income subject to tax. The separate accounting method determines the income of related corporations on a corporation-by-corporation basis and does not take into consideration the income of related corporations not subject to tax within the taxing jurisdiction.

The separate accounting method is generally premised upon the use of "arm's-length" pricing in transactions between related parties. Under this principle, the prices or charges on transactions between related parties should be the same as if the transactions occurred between unrelated parties. However, in many situations, related corporations may realize an overall tax benefit for the affiliated group by shifting income between affiliates and not charging an "arm's-length" price.

Internal Revenue Code (IRC) Section 482 was enacted to prevent any arbitrary shifting of income between affiliates. The Internal Revenue Service (IRS) conducts Section 482 audits to determine if the related parties have charged an "arm's-length" price and, if not, what the "correct" price should be. This is commonly referred to as transfer pricing.

Under federal law, in determining the Puerto Rico and possessions tax credit, a possession corporation[1] may elect to attribute some of the income from intangible property[2] to the U.S. corporation by use of either the cost sharing method or the profit split method. If neither method is elected, virtually all of the income attributable to the intangible property is considered U.S. source income. Thus, a possession corporation is treated as a contract manufacturer not owning any intangible property, even if the intangible property was purchased from unrelated parties or developed by the possession corporation itself.

The Puerto Rico and possessions tax credit is terminated for tax years beginning after December 31, 1995. However, special phase-out rules apply in the case of existing credit claimants. Existing credit claimants may continue to claim the credit throughout the last tax year beginning before January 1, 2006. For tax years beginning in 2006 and thereafter, the credit is scheduled to expire.

If the cost sharing method is elected for federal purposes, the possession corporation is required to pay its affiliates for its share of product research and development costs incurred by the affiliates during the year. The cost share payment cannot be less than the cost share payment that would be required under IRC Section 482.

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[1] Possession corporations are U.S. incorporated entities located in U.S. possessions, most notably Puerto Rico, which have elected the benefits of Internal Revenue Code Section 936.

[2] Intangible property includes patents, inventions, copyrights, trade names, and trademarks.

If the profit split method is elected for federal purposes, the taxpayer is permitted to arbitrarily attribute 50% of the manufacturing profits (for the product lines covered by the profit split method) to the possession corporation. If the federal profit split amount reportable by the possession corporation is less than the amount of net income reported by the possession corporation on its books, the possession corporation will usually remit a payment to the U.S. shareholder.

If the reverse occurs, the U.S. parent corporation remits a payment to the possession corporation. Procedurally, the IRS does not conduct Section 482 audits of corporations electing the profit split method in determining the Puerto Rico and possessions tax credit and treats that method as properly reflecting the income of the electing corporation.

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The fundamental difference between the unitary method and the federal separate accounting method discussed above is that the prices or charges on transactions between related parties are disregarded under the unitary method, as opposed to adjusted under separate accounting rules.

As an alternative to the unitary method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. Therefore, in a water's-edge combined report, the allocation of income between affiliated corporations, some of which are members of the water's-edge group and some of which are not, is relevant to the correct determination of income from California sources.

Generally, possession corporations are excluded from the water's-edge combined report group, unless:

- the possession corporation's average United States factor is equal to 20% or more; or
- the possession corporation earns U.S. source income that is effectively connected with a U.S. trade or business, and if the possession corporation is considered a taxpayer for California purposes.

California law requires the department to conduct transfer-pricing audits (IRC Section 482 audits) to ensure that taxpayers include the correct amount of income in the water's-edge combined report. The department is not required to perform an audit if the IRS is examining the taxpayer for the same year or years on the same issues. If the IRS does conduct a detailed IRC Section 482 audit, California law specifies that it shall be presumed correct and that the results of the federal audit apply for state tax purposes. This presumption can be overcome if either the FTB or the taxpayer demonstrates that any one of the following apply:

- An adjustment or the failure to make an adjustment was erroneous.
- The results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons.
- Substantially the same federal tax result was obtained under other IRC sections.

If the IRS does not conduct a IRC Section 482 audit of any particular taxpayer, California law specifies that no inference shall be drawn for state purposes from this failure.

California law does not conform to the IRC Section 936 elections relating to the profit sharing or profit split methods used in computing the federal Puerto Rico and possessions tax credit. For California purposes, IRC Section 482 governs the relationship between a possession corporation and its U.S. affiliates.

THIS BILL

This bill would create a presumption that if a taxpayer elects to use the profit split method (IRC Section 936) for federal purposes, the result clearly reflects income of the taxpayer or taxpayers in the water's-edge group for California purposes. Furthermore, in applying the profit split method for California purposes, it would be presumed that FTB followed the rules, regulations, and procedures for transfer pricing.

This bill would specify that if a taxpayer at any time elected the profit split method for federal purposes, the profit split method **must** be used for state purposes. If, however, a taxpayer does not elect to use the profit split method for federal purposes, the profit split method could not be used for state purposes. Thus, this bill would essentially require the use of the profit split method for California purposes if the profit split method was ever elected for federal purposes.

IMPLEMENTATION CONSIDERATIONS

The department has identified the implementation concerns listed below. Department staff is working with the author's office to resolve these matters.

- As a tax levy, this bill would apply to taxable years beginning on or after January 1, 2001. According to the author's staff, the author intends the bill to apply to audits in progress and thus apply to all open years. The author's staff has requested amendments to apply the bill to all open years.

- The bill is internally inconsistent. Subparagraph (A) of paragraph (4) of subdivision (b) of Section 25114 would presume that the profit split method is correct. This presumption is rebuttable pursuant to Evidence Code Sections 600 to 647. However, subparagraph (B) provides that if the taxpayer at any time had a federal election in place to use the profit split method under Section 936 of the Internal Revenue Code, then the profit split method shall apply for California purposes, thus providing what could be construed to be a conclusive presumption that the profit split method is correct. Consequently, it is unclear if the presumption is rebuttable. The author's staff has requested amendments to make the presumption conclusive and not subject to Evidence Code Sections 600 to 647.

TECHNICAL CONSIDERATIONS

The language of subparagraph (B) of paragraph (4) of subdivision (b) of Section 25114 is cumbersome and confusing. Amendments being provided to the author to resolve implementation considerations will remove this language.

LEGISLATIVE HISTORY

SB 2125, Peace (1999/2000) was identical to this bill. SB 2125 was held in the Senate Revenue and Taxation Committee.

AB 1208, Assembly Revenue and Taxation Committee (1999/2000) contained a similar provision. AB 1208 would have created a rebuttable presumption for possession corporations that elect the profit split method. The presumption would be that the allocation of combined taxable income under the profit split method is a proper allocation under transfer pricing rules. The profit split method provision was amended out of AB 1208.

AB 1467, Scott (1999/2000) was almost identical to this bill. It was held in Assembly Appropriations Committee and died because it did not pass the house of origin by the constitutional deadline for two-year bills.

OTHER STATES' INFORMATION

Review of Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York tax laws provided no information regarding the profit split method. It could not be determined if this issue occurs for these states. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

If the implementation considerations were resolved, this bill would not significantly impact the department's costs. To the extent that this bill simplifies or reduces transfer-pricing audits and reduces disputes between taxpayers and the department, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

ECONOMIC IMPACT

<u>Tax Revenue Estimate</u>

Based on data and assumptions discussed below, this bill would result in the following revenue losses. Estimates were derived assuming a conclusive presumption.

Estimated Revenue Impact of AB 377 As Introduced 2/20/01 [$ In Millions]		
2001-02	2002-03	2003-04
-$22	-$21	-$26

Estimates assume the bill would be effective January 1, 2001, and would apply to all years for which the statute of limitations is still open.

Tax Revenue Discussion

The tax differential between following IRC Section 482 transfer-pricing rules and IRC Section 936 profit splitting rules would determine the revenue impact of this bill. Based on an analysis of tax returns of corporations under audit for transfer pricing issues, tax differentials were approximated and projected to years when uninitiated audits for open years would likely be completed. Due to the sunset of Section 936 for income years beginning on or after 2006, the level of revenue losses would begin to decline starting in later fiscal years. Because an expired federal election would still be binding for state purposes, potential revenue losses would continue to exist, although likely to be insignificant, as long as corporations that made the federal election continue their business activities in Puerto Rico.

ARGUMENTS/POLICY CONCERNS

- This bill specifies that if the taxpayer at any time elected to use the profit split method for federal purposes, then the profit split method shall apply for California purposes. Thus, the profit split method would be required for California purposes even if the taxpayer later elects out of the profit split method for federal purposes. In addition, the profit split method would be used for California purposes even after the federal provisions expire in 2006. This could be resolved by amending the bill to clarify that the profit split method would apply for only those taxable years that the method is applicable for federal purposes.

- IRC Section 482 (transfer-pricing) audits are very resource-intensive for the department and the taxpayer. For this reason, California is not required to conduct a IRC Section 482 audit if the IRS has conducted such an audit. With a conclusive presumption that the profit split method elected under federal law provides the correct value under IRC Section 482, this bill would reduce the number of IRC Section 482 audits the department is required to conduct.

  On the other hand, the profit split method may not accurately reflect California income for those taxpayers that are using that method. Further, the profit split method was the result of a policy implemented by the federal government to encourage economic growth in Puerto Rico and other U.S. Possessions. California may not have the same policy reasons for encouraging economic growth in the U.S. Possessions.

- During the negotiations for the original water's-edge legislation, taxpayers that advocated treating possession corporations outside of the water's-edge agreed to be subject to the IRC Section 482 transfer pricing rules. It was contemplated that full transfer pricing audits, either by the federal government level or by California, would have to be conducted to ensure that income was not inappropriately moved outside the water's-edge to lower California tax. This bill would rescind part of those water's-edge statutory provisions. In addition, this bill would essentially provide possession corporations double preferential treatment compared to other foreign corporations because other foreign corporations (1) are subject to IRC Section 482 transfer-pricing audits, and (2) must suffer the tax consequences of adjustments for failure to produce an arm's length price.

- Proponents of this bill argue that it would provide California taxpayers with certainty regarding their income tax liabilities, at the same time saving California certain costs of tax administration.

- This bill would ease the computation of the California tax return because it would allow taxpayers to use the profit amounts used for federal purposes for determining state income.

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